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IN THE

Supreme Court of the United States

October Term, 1969

No. 1180

TODD SHIPYARDS CORPORATION,

Petitioner,

— vs. —

MASTAN COMPANY, INC., et al.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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Supreme Court of the United States

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No. .....

MASTAN COMPANY, INC.,
Respondent,

WILLIAM STEINBERG, *et al.*,
Applicants for Intervention,

— VS. —

STEAMSHIP SAPPHIRE SANDY,
Defendant,

TODD SHIPYARDS CORPORATION,
Petitioner.

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Defendant,

TODD SHIPYARDS CORPORATION,

Petitioner.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioner prays that a writ of certiorari issue to review the Judgment of the United States Court of Appeals for the Third Circuit, entered in the above-entitled cause on November 18, 1969 (H R. 7).

Opinions and Order Below

The unreported opinion of the United States District Court for the District of New Jersey (H R. 35), printed

in Appendix A hereto, *infra* at 7a.[1] The opinion of the Court of Appeals (II R. 6); reported in 418 F.2d 177, printed in Appendix A hereto, *infra*, at 1a.

Jurisdiction

The opinion of the Court of Appeals was filed on November 18, 1969 (II R. 6; 1a). The jurisdiction of this court is invoked under 28 U.S.C. § 1254(1).

Questions Presented

1. Whether an interpretation of the Ship Mortgage Act, 1920, which upholds the validity of a ship mortgage when at the inception of the mortgage transaction the hopelessly insolvent financial condition of the mortgagor is known to both the mortgagee and mortgagor should be permitted to stand when its effects are to encourage the reckless extension of credit to the substantial injury of the maritime industry and the American economy in general.

2. Whether an interpretation of The Ship Mortgage Act, 1920, which denies preferred maritime lien status to a ship repairer under 46 U.S.C.A. § 953 who was defrauded into making repairs should be permitted to stand when the decision is in conflict with decision of Federal District Courts in other districts and is of monumental federal importance since the effect of the decision is to discourage the extension of credit by ship repairers and other persons who normally furnish necessaries to seagoing vessels.

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[1] The transcript of record is in two volumes: the appendix of appellant below and the record in the Court of Appeals. These two volumes are cited herein as I R., and II R., respectively. The pages of Appendices A and B annexed hereto are cited herein and numbered "1a", "2a", "3a", etc.

3. Whether in the interests of justice and fairness this court should review the decision below which refused to apply the doctrine of marshalling of assets when the mortgagee had sources of recovery other than the ship proceeds sufficient to substantially diminish if not fully satisfy its claim, while the maritime lienors had no other sources of recovery aside from the ship proceeds, and when the holding below is in conflict with the holding in another District Court.

Statutes Involved

The Ship Mortgage Act of 1920, Section 922(a)(3), 952(a), (b); New York Debtor and Creditor Law (Secs. 273, 274 and 276); N. J. S. A. 14:14-2, The Bankruptcy Act, 1938 (Sec. 67d(3) Benedict on Admiralty, Sec. 78 (1967 Supplement), Collier's on Bankruptcy, Vol. 4, p. 548, are set forth in Appendix B hereto, *infra* at 20a to 24a, inclusive.

Statement of the Case

On or about March 13, 1967, The Mastan Company (hereinafter Mastan) filed its libel in the United States District Court for the District of New Jersey, to foreclose a fleet mortgage which it claimed to hold on the S/S "Sapphire Sandy" (hereinafter "Sandy"), S/S "Sapphire Etta", and the S/S "Sapphire Gladys", all in the record ownership of Sapphire Steamship Lines, Inc. (hereinafter Sapphire). Mastan alleged compliance with the *Ship Mortgage Act, 1920* (46 U.S.C.A. Sec. 911, *et seq.*). The mortgage provided that the separate discharge value of each of the vessels was the same as the full amount of the mortgage indebtedness, namely, $1,296,000. Sapphire, on or about March 13, 1967, filed a Chapter XI petition for arrangement in the Federal District Court for the Southern District of New York and the "Sandy" was arrested in the District of New Jersey by the United States Marshal. Foreclosure libels were also filed under the Fleet Mortgage against the "Gladys" and "Etta" and those vessels were arrested in Rotterdam, Netherlands.

Todd Shipyards Corporation (hereinafter Todd) filed its libel against the "Sandy" for repairs performed to the vessel and other maritime lien creditors also filed libels for their claims. The "Sandy" was subsequently sold by the United States Marshal for the District of New Jersey and after payment of costs and expenses incurred by the Marshal during the period the vessel was in *custodia legis* and subsequent wage claim payments made pursuant to the order of the federal district court, there remains in the registry of the federal district court for distribution, the sum of $55,085.37.

On December 28, 1965, when Sapphire was in a hopelessly insolvent condition to the knowledge of Mastan, the parties entered into a loan agreement (I R. 199) under which Mastan agreed to "lend" Saphhire the sum of $1,296,000.

On December 29, 1965 the first part of the loan closed and the sum of $864,000 was loaned to Sapphire. No part of the $864,000 was turned over to Sapphire. Sapphire executed a letter of instructions dated December 20, 1965, which letter was prepared by Mastan. The said letter provided that Mastan was authorized to remit the following amounts to the parties so named:

(a) $205,000. towards the purchase of the "Overseas Joyce" (now "Sapphire Sandy"), from Overseas Carrier Corporation;

(b) $495,000. towards the purchase of the "Natalie" (now the "Sapphire Gladys"), from International Carriers;

(c) $100,000. to be held pending completion of certain ship repairs. The check was made payable to Sapphire and was endorsed by it over to Mastan;

(d) $64,000. representing a finance fee. This check was made payable to the order of Sapphire and was endorsed by it to Mastan.

On December 29, 1965, Sapphire executed a promissory note in the amount of $861,000., which was payable monthly in the amount of $39,840. for a term of 2 years, the maturity date of the note being December 29, 1967. Sapphire further executed a collateral note which was guaranteed by principals of Sapphire and various corporate affiliates. In addition, Sapphire executed a document entitled "A First Preferred Fleet Mortgage" on the "Gladys" and "Sandy" (1 R. 228).

The loan provided for interest at the rate of 6% per annum. The mortgage note attached to the First Preferred Fleet Mortgage made no provision for additional or penalty interest in the event of a default on the part of Sapphire. The $64,000. finance fee was an 8% interest charge on the amount advanced: namely $800,000. for a term of 2 years. Sapphire never had use of the finance charge since, as described above, the check was immediately endorsed over to Mastan, yet Sapphire agreed to and paid interest at the rate of 6% per annum on the finance charge of $64,000. In addition, the sum of $100,000., which was held in escrow by Mastan, was used in computing the 8% finance charge, notwithstanding that said sum was not turned over to Sapphire. In fact, $60,000. of the $100,000. was subsequently applied by Mastan against monthly payments coming due under the terms of the loan.

On January 21, 1966 the second part of the loan transaction was closed. Sapphire signed a promissory note in the amount of $432,000. and a letter of instructions

again prepared by Mastan authorizing the distribution of the sum of $432,000. as follows:

(a) $400,000. payable to Oceana Clippers, Inc. for the purchase of the S. S. Sapphire Etta;

(b) $32,000. finance fee payable to Sapphire and immediately endorsed over to Mastan.

The second part of the transaction followed the pattern of the first part of the transaction. The finance fee was computed at the rate of 8% for a 2 year period on the loan of $400,000. This finance fee was never in the hands of Sapphire, except merely to endorse the check back to Mastan. Notwithstanding, Mastan charged interest at the rate of 6% per annum on the finance fee of $32,000. as well as 6% interest per annum on the $400,000. Also on January 21, 1966, Sapphire executed an extension to the First Preferred Fleet Mortgage thereby bringing the Sapphire Etta into the mortgage document. The $432,000. mortgage note, like the first mortgage note for $864,000., made no provision for additional or penalty interest in the event of a default on the part of Sapphire.

Gold, Assistant Secretary and House Counsel to Mastan, testified that Mastan had no knowledge of the financial difficulties of Sapphire at the time the loan agreement and mortgage were executed. Gold's testimony was not accepted by the presiding trial judge, Judge Wortendyke, when the contrary finding appeared in the federal district court's Opinion of November 26, 1968 (1 R. 35, 7a).

At page 4 of the federal district court's opinion, Judge Wortendyke stated:

> "The evidence is uncontradicted that both the mortgagor and mortgagee were fully aware *when the mortgage loans were made* that the mortgagor was insolvent." (Emphasis supplied.)

And further at page 8 of the court's opinion, Judge Wortendyke stated:

> "The testimony of Mastan's Vice President, McGreevey, disclosed that he received on or about August 10, 1966 a certified financial statement, dated July 29, 1966, from which it appears that Sapphire's financial condition deteriorated during the period commencing with the date of the making of the initial loan, and that Sapphire was hopelessly insolvent."

The Special Master denied the financing charges and penalty interest claimed by Mastan on the ground that such claims were excessive in amount. This finding was confirmed by the United States District Court. Accordingly, the Master reduced the Mastan claim from $1,052,754.34 to $866,580.43.

Subsequent to the placement of the mortgage in December, 1965, the "Sandy" was tendered to Todd for repairs at its Brooklyn plant in May, 1966 and Todd furnished labor, materials and supplies in the performance of such repairs to the reasonable and agreed value of $33,293. Although the necessity for repairs was obviously known to Mastan as well as to Sapphire and the credit of the "Sandy" was involved, neither Mastan nor Sapphire nor the vessel acting through those in charge of the work, and knowledgeable with respect to the financial condition of Sapphire, made any disclosure to Todd as to the hopelessly insolvent condition of Sapphire.

Furthermore, subsequent to the placement of the mortgage on the "Etta", the said vessel was tendered to Todd for repairs at its Brooklyn, N.Y. plant. In December, 1966 and January 1967 Todd furnished labor, materials and supplies in the performance of such repairs to the reasonable and agred value of $365,136. Here again, although the

necessity for repairs was obviously known to Mastan as well as to Sapphire and the credit of "Etta" was involved, neither Mastan nor Sapphire nor the vessel acting through those in charge of the work, and knowledgeable with respect to the financial condition of Sapphire, made any disclosure to Todd as to the hopelessly insolvent condition of Sapphire.

At the present date the Court of Rotterdam, Holland has before it the proceeds of sale of the vessels, "Etta' and "Gladys". The court in Rotterdam in rendering its opinion on distribution of the funds which it holds in its registry as a result of the sale of the aforementioned vessels will undoubtedly be substantially influenced by the decision of this Court. The said sum held in the registry of the Rotterdam court is $731,555.25.

Reasons for Granting the Writ

1. The language of the Ship Mortgage Act, 1920, is sufficiently broad to support an interpretation which would deny validity to a ship mortgage which when executed finds the mortgagor in a hopelessly insolvent financial condition with such insolvency known to both the mortgagee and mortgagor. To decide otherwise, as did the Court of Appeals, encourages and promotes the reckless extension of credit to the substantial injury of the maritime industry and the American economy in general.

Under the Ship Mortgage Act, in order for a ship mortgage to obtain validity against third persons and thereby to gain priority as a preferred ship mortgage, the mortgagor and mortgagee must comply with the prescribed statutory requirements. See *Morse Dry Dock & Repair Co. v. Steamship Northern Star*, 46 S. Ct. 589; 271 U.S. 552, at p. 556; 70 L.ed. 1082, at p. 1084; *Detroit Trust Co. v. The Barlum*, 293 U.S. 21 (1934).

As appears in Section 922 (a) (3), the Ship Mortgage Act requires the filing of an affidavit "to the effect that the mortgage is made in good faith, and without any design to hinder, delay, or defraud any existing or future creditor of the mortgagor or any lienor of the mortgaged vessel."

The reason for the affidavit of good faith requirement is found in the legislative history of the Act, namely, the potential use of a mortgage as a ready instrument of fraud. The subject was given extended consideration during the Congressional Hearings that preceded the passage of the Act in 1920. As originally drafted by Ira A. Campbell, Esq., the proposed Act did not contain any requirement for the execution of a "good faith affidavit". Testimony was given by Judge Hough, an admiralty judge of note, who sat for many years in the Circuit Court of Appeals for the Second Circuit, that a mortgage on a vessel for more than 50% of its value would "make it an implement of fraud". (*H.R.* 9419, *Part Four*, *page* 7).

To meet this objection, as appears in the following extract, the proposed Act was modified to include a requirement that the mortgage must secure a "bona fide indebtedness":

House Committee Reports (*H.R.* 9419) *Part* 5, *pages* 10, 11, *Mr. Campbell*:

> "*** In the first section of the bill I make a change by providing that the mortgage shall not be valid unless . . . the mortgage secures a bona fide indebtedness to the amount stated in the mortgage. *** I think this thing is striking at watering mortgages. I put that in there to meet Judge Hough's objection when he said this is a potent instrument of fraud, because a mortgagor who is a crook can mortgage to a dummy who is a crook and, by foreclosing the dummy, cut off maritime liens which are subordinate to the lien of the mortgage. *** I try to

> meet that particular situation, and I believe I do meet it, by providing that a mortgage, so far as this statute is concerned, shall not be valid and subject to this act unless it represents a bonafide indebtedness."

Objections then made to the "bona fide indebtedness" provision on the ground that it would be violated if the mortgage were later sold at a discount (J. Davis—*House Hearings, Feb.* 6, 1920; *page* 11) resulted in its replacement by the requirement for a good faith affidavit (Letter by Campbell to Senate, 2-19-20, included in Senate record on 3-13-20, at page 2071).

The filing of such affidavit has therefore been construed by the courts to be a jurisdictional requirement in order to confer preferred status on the ship mortgage. The mere formality of filing the affidavit is not sufficient; the affidavit must be honest, the indebtedness must be bona fide and the transaction not tainted with fraud. See *Lake Jackson State Bank* v. *Oil Server Kingfish Too*, 240 F. Supp. 150 (D.C. Texas, 1965); *Pascagoula Dock Station* v. *Merchants Marine Bank*, 271 F.2d 53 (CA 5, 1959).

As stated in the leading case of *Pascagoula Dock Station, supra*,

> "Such statute requires an affidavit of good faith by the mortgagor, and we may assume that, on proof and finding that the mortgagor and mortgagee undertook to use the device of a preferred ship mortgage in defraud of creditors, and hence with a design to hinder, delay and defraud any existing or future creditor or any lienor of the vessel, the mortgage would lose its preferred status . . ." (at page 54).

Numerous other cases, in discussing the requirement of this affidavit, have provided that substantial compliance with the statute is all that is required in the absence of

fraud, in order to effectuate the object of the statute which is to encourage investment in shipping and in ship mortgages. Where fraud appears, however, the courts have stated that the statute demands a strict construction in order to protect creditors and lienors of the mortgagor. With this proposition the Court of Appeals below concurs. Also see *Pascagoula*, *supra*; *The Nan B*, 78 F. Supp. 748 (D. Alaska, 1948); *Lake Jackson State Bank*, *supra*; *Gulf Coast Marine Wharfs, Inc. v. The J. R. Hardee*, et al., 107 F. Supp. 379 (D.C. Texas, 1952). In each of the foregoing cited cases the court found no acts of fraud, but only various irregularities in the affidavits filed in accordance with Section 922(c), and accordingly, none of the cases are applicable on their facts, but are precisely in point as to the proposition of law herein being advanced. Furthermore, *Benedict on Admiralty*, has adopted the language of the cases cited herein, and states in his treatise at Section 78 (1967 Supplement) as follows:

> "Were it to be proven that the mortgagee used the devise of the preferred ship mortgage in fraud of creditors, existing or future, the mortgage would lose its preferred status" (citing *Pascagoula*).

In *The Nan B*, *supra*, the Court said:

> "It is the opinion of the court that the statute here involved should be strictly construed so far as the protection of creditors and lienors from *fraud and like acts* is concerned, but liberally construed to effectuate the object of the statute to make investments in shipping and ship mortgages more attractive and secure" (at page 79). (Emphasis added.)

The foregoing cases clearly demonstrate and the Court of Appeals below wholeheartedly concurs, that the mere filing of an affidavit required by the Act is not sufficient to confer preferred status on the mortgagee. The courts will look behind the filed affidavits and examine the trans-

action between the parties and if the facts warrant, will void the mortgage transaction and deny it preferred status in order to protect creditors.

In order to precisely ascertain Congressional intention in adopting the language of Section 922 (a) (3) of the Act, reference to other bodies of law should be made. The origins of the language found in Section 922 (a) (3) of the Act are in the law of fraudulent conveyances where almost identical language is contained in the *Uniform Fraudulent Conveyance Act* which has been adopted in numerous states, including New Jersey and New York.

The New York version of the *Uniform Fraudulent Conveyance Act* applies to this case since the provisions of the loan agreement between Mastan and Sapphire sets forth that New York Law shall govern the transaction between the parties. It must be emphasized at this point that we are not introducing New York law to support a contention that the said law controls the disposition of this case. We are introducing New York law exclusively for the purpose of developing a clear and more precise understanding of the Congressional intent found in *Section 922 (a) (3)* of the *Ship Mortgage Act, 1920*. It is obvious that the Court of Appeals below rejected New York law as controlling the disposition of the controversy and failed to consider New York law as an aid in the proper construction of *The Ship Mortgage Act*, 1920.

The New York statute contains language so similar to that found in *Section 922 (a) (3)* that it is obvious that Congress accepted the concept of such state fraudulent conveyance act when drafting the federal provision. The pertinent provision of the New York statute reads as follows:

> "Every conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud

> either present or future creditors is fraudulent as to both present and future creditors." (Sec. 276, New York Debtor and Creditor Law.)

Under this statute, New York courts have repeatedly determined that conveyances or transfers made with intent to defraud creditors are void. See *Pattison* v. *Pattison*, 301 N.Y. 65, 92 N.E.2d 890; *Harts* v. *Horowitz*, 21 Misc. 2d 631, 195 N.Y.S.2d 414. Similarly conveyances made with intent to hinder or delay creditors violate the statute as do conveyances made with fraudulent intent to obstruct or impede a creditor's ability to collect his debt. See *Nicholson* v. *Leavitt*, 6 N.Y. 510; *Walworth Mfg. Co.* v. *Burton*, 82 App. Div. 637, 81 N.Y.S. 873. The requisite intent to hinder, delay, or defraud creditors may be inferred from the facts and circumstances involved in the particular case. See *Cole* v. *Tyler*, 65 N.Y. 73; *In Re*: *Berkley*, 174 App. Div. 205, 160 N.Y.S. 1093; affirmed 223 N.Y. 597, 154 N.E. 621; *Lee* v. *State Bank & Trust Co.*, 54 F.2d 518, 85 A.L.R. 216; *Wheeler* v. *Lewis*, 203 App. Div. 222, 196 N.Y.S. 817.

Furthermore, under *Section 273* of the *New York Debtor and Creditor Law*, the fact of fraud is presumed as a matter of law where a person making a transfer is, or will be rendered insolvent, and the transfer is without fair consideration. The same result follows under *Section 274* where a transferee engaged in business makes a transfer without fair consideration when, thereafter, the property remaining in his hands is an unreasonably small capital for the operation of his business. These concepts are incorporated in the requirements of *Section 922 (a) (3)* of *The Ship Mortgage Act*, 1920, by the adoption therein of language similar to that in the cited New York law.

Mastan and Sapphire have denied the fraudulent intent to hinder, delay or defraud creditors in their testimony at hearings conducted before the Special Master. Notwithstanding that the mortgagor was hopelessly insolvent at

the inception of the mortgage loan to the knowledge of both the mortgagor and mortgagee, the Special Master has found that the parties acted in good faith and transaction was free of fraud. The Federal District Court and the Court of Appeals below have confirmed the Master's findings of fact, notwithstanding the insolvent condition of the mortgagor. A careful examination of the testimony before the Special Master clearly demonstrates that the said testimony is contradictory to the findings of the Special Master, making such findings contrary to the weight of the evidence.

Frank Morelli testified (I R. 112) that in the capacity of Acting Secretary of Sapphire, he met on or about December 15, 1965 with John McGreevey of Mastan for the purpose of discussing a possible loan to Sapphire. At that meeting Morelli gave financial statements of Sapphire to McGreevey. McGreevey, in his testimony, confirmed said meeting with Morelli and acknowledged the receipt of the financial statements, except that he testified he did not meet with Morelli until December 28, 1965 (I R. 127). Morelli testified (I R. 114) that he advised McGreevey that Sapphire's loss for the period February 1, 1965 through November 30, 1965 approximated $900,000. McGreevey in his testimony did not deny receiving such information. Morelli also testified (I R. 117) that Sapphire had exhausted the money market in New York and other areas and was unsuccessful in obtaining a mortgage loan until the company met with Mastan. Accordingly, Morelli said that Sapphire was willing to borrow the money from Mastan without concern for the interest rate.

John R. McGreevey was subpoenaed by Todd to testify on March 14, 1968. He stated that he is a Vice President of Mastan, having been employed since 1949 and that his duties involved credit and loan transactions. He acknowledged that he was one of the persons who approved the

loan to Sapphire and was the person who met with Frank Morelli on December 28, 1965. He admitted receiving and did produce a financial statement of Sapphire for the period ending September 30, 1965 (1 R. 307). He further acknowledged discussing this statement with Morelli (1 R. 128). McGreevey admitted (1 R. 129) that the September 30, 1965 statement reflected a loss from February 1, 1965 to September 30, 1965 of $197,942. In addition, he testified that Schedules 1 and 2 accompanying the financial statement estimated that Sapphire expected to suffer an additional loss from September 30, 1965 of $10,679, on uncompleted voyages. Upon further examination on this point by Special Master Freeman, McGreevey admitted (1 R. p. 130) that the estimated loss for the period up to December 30, 1965 excluded administrative and general expenses, which, for the period through December 30, 1965 totalled $75,000.

McGreevey conceded (1 R. pp. 131 to 136) that he did not request additional information concerning the changes in assets of Sapphire from those reflected on the financial statement dated September 30, 1965 to and up to the period December 28, 1965.

The following question was asked of McGreevey (1 R. p. 135):

> "Q. Mr. McGreevey, the statement of September 30, 1965—strike that. Did you point out to Mr. Morelli or discuss with him the fact that this statement shows that Sapphire Steamship Lines as of September 30, 1965 was insolvent? A. (at page 26) I don't think the word insolvency was used at that time. I think I asked him that question or pointed it out to him."

Again, at page 26 of the transcript (1 R. 137), McGreevey was asked:

> "Q. Did you further discuss with Mr. Morelli the fact that the liability of Sapphire Steamship Line exceeded the assets as of September 30, 1965? A. I discussed that with Mr. Morelli."

McGreevey admitted, on questioning (1 R. p. 138), that the September 30, 1965 financial statement was the only financial statement relied upon by Mastan in making the loan to Sapphire.

Mr. Thompsen, Treasurer of Sapphire, testified (1 R. p. 121), that the loss sustained by Sapphire for the period through December 31, 1965 approximated $900,000. and that the company showed a negative net worth.

The above excerpts of the transcripts clearly establish that prior to the making of the loan to Sapphire, Mastan had in its possession a financial statement of Sapphire which unquestionably established that the company was insolvent. Furthermore, the statement showed that the company had experienced a catastrophic loss of $497,942. for the period ending September 30, 1965 and an estimated loss of an additional $10,769. for the period September 30 through December 30, 1965, exclusive of administrative expenses which were incurred during this period.

With these facts established the United States District Judge concluded in his opinion of November 26, 1968 (1 R. 35, 7a) that:

At page (4),

> "The evidence is uncontradicted that both the mortgagor and mortgagee were fully aware when the mortgage loans were made that the mortgagor was insolvent."

and at page (8),

> "The testimony of Mastan's Vice President, McGreevey, disclosed that he received on or about August 10, 1966 a certified financial statement, dated July 29, 1966 (PM46) from which it appears that Sapphire's financial condition deteriorated during the period commencing with the date of the making of the initial loan, and that Sapphire was hopelessly insolvent."

The significance of Mastan's knowledge of Sapphire's financial condition was explored by Israel M. Pogash, the expert witness called on behalf of Todd. Special Master Freeman proposed a hypothetical question to Pogash as follows (I R. 153):

> "Mr. Freeman: Based on all the facts that you have before you and your projection of the voyages terminated after September 30, is it your opinion that when this loan was granted, when the mortgages were executed and delivered and properly documented and endorsed and recorded, in your opinion as a Certified Public Accountant with over forty years experience in this particular category, based on reviewing and preparing and inspecting and examining financial statements of various business operations, is it your opinion that this mortgagor is in a position on the business that he was doing for this period of time, if he attained this $1,264,000.00 [$1,296,000.00] loan, would he be able to repay $54,000.00?"

Pogash answered (I R. 158):

> "The Witness: Based on my examination of this balance sheet it was my opinion that this company could not meet an obligation of $54,000.00 a month in repayment of an acquisition of fixed assets."

Thereupon Pogash was asked another hypothetical question (I R. 158):

> "Q. Mr. Pogash, again, hypothetically, you are asked as a professional consultant to examine this balance sheet for the purposes of determining if a loan in the amount of one point three million dollars, which was made for the acquisition of fixed assets, whether a payment over a two-year period of $54,000.00 a month, and the presentation of this balance sheet, what would your opinion be to a prospective lender in making or not making this loan?"

Pogash said in response (I R. 159):

> "The Witness: It would be advice to a lender not to make such a loan because, as I stated in my prior answer, it would be my opinion that the company could not meet the obligation as it matured."

McGreevey testified that demands were made of Sapphire to inject additional capital into the corporation and effective January 21, 1966 $355,000. was placed in the corporation in the form of capital. It is significant to note that the bulk of the additional capital was not put into the corporation until after the loan was made by Mastan to Sapphire. Pogash testified (I R. 161) that his opinion would not change, namely that Sapphire could not meet the $54,000. monthly payment on the mortgage loan, even with the infusion of this additional capital since additional losses sustained by the company from the period September 30, 1965 through December 30, 1965 more than offset the additional capital injected into the corporation.

Pogash further testified (I R. 175) that if mortgage payments were made by Sapphire, they were made at the expense of other creditors.

McGreevey admitted receiving on August 10, 1966, a certified financial statement of Sapphire prepared by Arthur Andersen & Co. He acknowledged that in reliance upon the July 29, 1966 financial statement (1 R. 301), he approved an extension of the mortgage and a reduction in the monthly payments.

As noted in the Statement of the Case, the finance fee charged to Sapphire for the extension was $52,817.73. The said sum was added to the mortgage debt and upon the execution of the extension documents, the 2% penalty was provided for in the event of default in payment by Sapphire.

The July 29, 1966 statement reflected that Sapphire, for the period February 1 through December 30, 1965 sustained a loss of $956,171. Notwithstanding that the July 29th statement reflected such a catastrophic loss, and was far in excess of the estimated loss contained in the September 30, 1965 statement, McGreevey testified that he did not question Sapphire's representatives in regard to the additional loss sustained, but on the other hand proceeded to approve an extension of the terms of the mortgage in August, 1966.

McGreevey was further questioned on the capitalization of the $956,000. loss as appears on the July 29th statement and the capitalization of preliminary vessel construction and financing costs in the amount of $365,082. McGreevey said he relied upon the certification of Arthur Andersen & Co. that same were proper assets. The financial statement submitted to McGreevey on September 30, 1965 did not contain such capitalization of losses or expenses. In fact, the expenses were never reflected on the September 30, 1965 statement but for the first time appeared on the July 29th statement in the amount of $365,082.

Pogash testified (1 R. 162) that the capitalization of the items just mentioned was improper and they were not

assets of Sapphire. Pogash stated that the loss should have been reflected as a reduction in capital in accordance with good accounting practices.

It is once again worthy of note to go back to Gold's testimony, who was the sole witness produced by Mastan. He testified (1 R. 70) that in August of 1966 he did not believe that Sapphire was insolvent and he further testified that Mastan did not receive a financial statement from Sapphire. Gold's denial of the receipt of a financial statement in August of 1966 is incredible in light of McGreevey's admissions. It is submitted that reliance on any part of Gold's testimony is unjustified and unwarranted in light of his lapse of memory on this most crucial and material factual element of the subject transaction. In order for the Special Master to have found the elements of good faith and the absence of fraud in the transaction, it was necessary for the Special Master to have accepted and believed Gold's testimony, which, it is submitted, was clear error on the part of the Special Master.

Special Master Freeman propounded the following question to Pogash (1 R. 165):

> "Mr. Freeman: I am not going into, Mr. Pogash —I'm not concerned so much with whether it is prudent or imprudent. I am only concerned with whether there was any fraud involved or whether there was this mortgage transaction that was executed to hinder or delay any future or present creditor, because when these vessels were purchased the mortgagee, The Mastan Company, the finance company, acquired a purchase money mortgage on these vessels. It is incumbent upon the mortgagor, the owner of the vessels, to make this affidavit.
>
> Now, such affidavit was made and it is attached to the mortgage. In your opinion, was this trans-

> action fraudulent in any way, or was it executed to hinder or delay any present or future creditors, in your opinion?"

Pogash responded (I R. 166):

> "The Witness: I would answer first that I am not in a position to judge whether or not there was any fraud. As far as I know, there was no fraud in connection with the issuance of the statement which presents the facts as they existed. However, it would appear to me that the creditors then existing, and future creditors were hindered because undertaking this obligation which, in my opinion, I gave as my opinion, was imprudent, would necessarily be to the injury of the present and future unsecured creditors."

It must be noted that Pogash's response as to the lack of fraud was limited only to the disclosures contained in the financial statements of September 30, 1965 and July 29, 1966. He rendered no opinion as to the legal conclusion to be drawn from the overall facts of the transaction which is within the province of this court, except for the obvious accounting conclusion that the result of the transaction necessarily injured both existing and future creditors of Sapphire. The Court of Appeals below (II R. 6;—a) clearly misconstrued Pogash's testimony on this point by interpreting it to mean that he was unwilling to categorize the transaction between the parties as "fraud".

Special Master Freeman furthermore asked Pogash if his opinion on the subject transaction would change if he were advised that additional capital was injected into the corporation. Pogash said (I R. 167):

> "The Witness: Well, if the stockholders in fact on any particular day introduced new capital to the extent of the introduction of new capital, that

surely doesn't hinder any existing creditor. It helps. Now, the use to which that is put, if that new capital was applied by the (sic) two operating costs or to liquidation of the liabilities or to any corporate purpose, it again helps the creditors. But if either by misjudgment or for whatever other reason, if it is applied to a purpose such as they apply to here, it obviously was to the disadvantage of the creditors unless this application resulted in extraordinary income and extraordinary amount of income which would put them in a position to take care of the secured creditor. Else they could not pay or acquire anything, and to the then existing creditor."

Pogash further said in response (1 R. 169):

"The Witness: That may very well be, but this company was hopelessly insolvent when this transaction was entered into that it seems imprudent to expect the acquisition of these vessels despite the input of additional capital to make this company solvent, so that it could pay its creditors."

Pogash furthermore said at (1 R. 170):

"The Witness: Let me come back. This delay and hinder the repayment of the claims of general creditors, this was a practical effect of this transaction in the posture of the financial position that this company found itself in when the transaction was entered into."

Special Master Freeman thereupon propounded the following question, at (1 R. 170):

"Mr. Freeman: You mean there wasn't sufficient income, projected in the future, to pay off present creditors and to hinder a few creditors by asserting what we call in admiralty a maritime lien

for necessaries? In other words, Todd Ship Building Company, if they made any repairs on this vessel after December 29, 1965, their rights would be impaired because they couldn't, succeed and serve a maritime lien."

Pogash responded (I R. 171):

"The Witness: I would not be surprised if that is exactly what happened here."

Pogash summarized his position as follows (I R. 186 and 187):

"A. Yes. Assuming that the three hundred and fifty-five thousand in additional capital was in or was subscribed for at least December 29, I find that the company's financial condition was worsened and the company was more insolvent despite the inflood of this new capital at December 29 than it was December 30, 1965. I will just take a moment to explain and give you my reasons.

The statement of March 31, 1966 (PM46) indicates in a footnote that the corporation lost in its operations through January 1 of 1966, which is at approximately the December 29 date, some eight hundred—nine hundred and fifty-six thousand and seventy-one dollars. That would indicate that between December 30 and December 29 or January 1st the corporation incurred the loss of three hundred and ninety-eight thousand dollars. This sum exceeded the amount of the additional paid in capital. So the insolvency was increased despite the fact that the new capital came into the corporation.

Q. Mr. Pogash, based upon your opinion as to the financial condition as of December 29, 1965, do you have an opinion in regard to any hindering or delay of existing or future creditors by virtue of

> the loan in the mortgage transaction as of that date? A. Again I can testify that as a result of a mortgage transaction of that kind with the acquisition of fixed assets and the amount set forth here, it would work to the disadvantage and hinderance of creditors then existing.
>
> Q. And future creditors? A. Yes."

Finally, Pogash summarized once again (I R. 188) why he believed existing and future creditors were impaired by virtue of this transaction.

> "The Witness: Let me explain. Admittedly, the three hundred and fifty-five thousand is in capital and benefits the corporation. There is no question about that. It is the application of the three hundred and fifty-five thousand that matters. The three hundred and fifty-five thousand was invested and the investment in fixed assets was in excess of the new capital four hundred thousand dollars in the fixed assets. That in itself doesn't change or impair the capital or the position, but the undertaking to repay these obligations within two years would impair the position of the creditors, because they did have to earn in excess of six hundred thousand dollars a year when in fact the position of this company was one, they were losing very substantial amounts of money . . ."

It is significant that Mastan failed to call its own expert in order to attempt to justify the good faith of the transaction in question. The lack of an expert on the part of Mastan implies that they could not obtain such testimony. Furthermore, Pogash's testimony standing alone, unchallenged, carries great weight in determining if good faith existed or did not exist in this transaction and if existing and future creditors were hindered or delayed as a result of this transaction.

The demise of Sapphire in March of 1967 highlights the lack of good faith in December of 1965 on the part of Mastan and Sapphire. As a result of Sapphire's financial collapse, the three vessels were sold—the "Sandy" here, and the Sapphire-Gladys and Etta in Holland—and Mastan is now asserting that its mortgage has preferred status over the rights of other maritime lienors. If this court denies the petition for a writ of certiorari, there will result an extinguishment of all other maritime liens and the inability of general creditors and maritime lien creditors to collect their debts.

The excerpts of the testimony set forth above clearly demonstrate that the mortgagor and mortgagee did not act in good faith as they are duty bound to so act in accordance with Section 922(a)(3) of *The Ship Mortgage Act, 1920*, and that the finding of the Special Master to the contrary was clearly erroneous.

Mastan should not be entitled to preferred status since neither it nor Sapphire acted in good faith but rather acted fraudulently, both actually and presumed in law, with the result that the scheme in which they were engaged was designed to, and did in fact, hinder, delay and defraud existing and future creditors of Sapphire. Existing creditors were injured, as Pogash testified, because the funds used to meet the monthly payments on the mortgage debt to Mastan were necessarily diverted from the payment of existing debts. Future creditors were injured, as Pogash testified, by their reliance upon the security of a maritime lien, which in this situation, was valueless if the mortgage is deemed preferred. The reliance which the maritime lien creditors, both present and future, placed on the vessel and on Sapphire was justified since a fair and reasonable mortgage loan would have left equity in the vessel over and above the mortgage. Additionally, future creditors rendering services or supplying materials to the vessel in question would not have done so if Mastan did not grant this fraudulent mortgage to Sapphire.

To give judicial approval to the transaction would in essence be a declaration to all lenders that they could enter upon a course of reckless conduct without fear of reprisal or penalty as long as they obtained a high secured position on the priority pole of the bankrupt debtor.

As found by the United States District Court, Mastan knew of Sapphire's insolvent condition when it made the loan. Any doubt as to Mastan's lack of good faith and fraudulent conduct in December, 1965 is erased when one reflects upon Mastan's actions in August of 1966. At that time Mastan extended the time for payment of the debt and increased the debt by an additional $52,817.73 finance fee after having just received the July 29th certified financial statement, which the United States District Court found clearly showed that Sapphire's financial condition deteriorated further and that Sapphire was hopelessly insolvent.

Mastan's action in August of 1966 is simple to analyze. It extended the terms of the mortgage since it already had liens on all of the assets of Sapphire, including the 3 vessels, the accounts receivable, the proceeds of all maritime insurance claims, and charter hire, thus concluding that all the equities in those assets were sufficient to repay the outstanding balance owing to it together with the additional finance charge which Mastan levied by reason of the extension.

An unusually similar situation was presented *In the Matter of Lea Fabrics, Inc.*, 226 F. Supp. 232 (D.C. N.J. 1964). In that case, the borrower, while insolvent, received a loan in the amount of 1.1 million dollars. The lender knew of the borrower's insolvency when granting the loan, and delivered the proceeds of the loan to third parties in payment of debts owed by the borrower, in return for which he received liens upon all of the borrower's available assets. The transaction was attacked by the borrower's Trustee in Bankruptcy as a preference under *N.J.S.A.*

14:14-2. (Now N.J.S.A. 14A:14-16). The ultimate findings by the court suggest that the transaction was subject to attack under the appropriate fraudulent conveyance act as well as N.J.S.A. *14:14-2.*

In rendering its opinion, the court said:

> "There was substantial evidence before the Referee that on May 29, 1957 when Lea (Borrower) Ardisco, Reldan and Stratford (lenders) entered into the agreement for participation in the $1,100,000 loan to Lea, and on May 31, 1957 *when the lending transaction was 'closed' Lea was insolvent to the actual or imputed knowledge of all the loan participants in whose behalf Ardisco acted in the transaction.* The transfer of Lea's equities as collateral for the loan completed Lea's financial ruin, while only an insignificant portion of the ostensible amount of the loan found its way into Lea's treasury for application to its continually mounting liabilities to other creditors . . . (Emphasis supplied).
>
> On May 31, 1957, when the criticized transfers were made, Ardisco had knowledge of the following facts: The real estate of Lea Fabrics was encumbered by three mortgages, in amounts aggregating $981,200, and its chattels by three mortgages in amounts aggregating $457,500. All of these mortgages were held by money lenders; two of the real estate mortgages and two of the chattel mortgages were held by Reldan Trading Corporation. All of the acceptable accounts receivable had been pledged to Inland Credit Corporation, Ardisco's affiliate, under an arrangement inferrably brought about through the collaboration of representatives of Reldan, Fassoulis, Ardisco, Inland and Lea. Lea's books had been inspected by Inland's representative in connection with the accounts rgeivable financing. Lea was compelled to pay prohibitive interest rates

for the use of money, *e.g.*, 5½% per month on its $365,000 obligation to Reldan. For a relatively small cash receipt for itself, Lea was compelled to pay a bonus of $115,000, an interest rate of 6% on its assumed principal obligation of $1,100,000, and to permit Ardisco to receive collections on the loan without applying them in reduction of principal. The loan closing stripped Lea Fabrics of its remaining equities, except for its inventory, with which to meet obligations of corporations other than Lea Fabrics. The preferred maritime mortgage taken by Ardisco as part of the loan collateral, and recorded two days *prior* thereto, recited that it was second only to a first mortgage held by the United States, whereas it was also subject to a second, unrecorded mortgage held by Reldan Trading Corp. and Stratford Factors. The law amply warranted the Referee in holding that notice of the foregoing facts constituted notice of the debtor's insolvency.

The transfer of Lea's assets, including all the intangibles and tangibles transferred to Ardisco on May 31, 1957 (neither party attacks the Referee's finding that the transfer of the tangibles was void), was, under the circumstances, void within the meaning of N.J.S.A. 14:14-2."

In the instant case, like *Lea Fabrics*, Sapphire was insolvent, Mastan knew of the insolvency when making the loan, and substantially all of the loan proceeds were paid to third parties other than Sapphire, and Mastan obtained liens on all of Sapphire's available assets (such as the vessels acquired, the proceeds of marine insurance claims, charter hire and freight and accounts receivable. The result of said transaction was the completion of Sapphire's financial ruin, all to the detriment and harm of existing and future creditors of Sapphire. Accordingly, the transaction lacked good faith, was fraudulent, and under the principles of *Lea Fabrics*, is null and void, and under

Section 922(a)(3) of *The Ship Mortgage Act*, as amended, is not entitled to preferred status.

Although the provisions of the *Bankruptcy Act* are not directly applicable herein to resolve the question of the preferred status of the mortgage, the provision of the *Bankruptcy Act* and the cases cited thereunder are relevant to the extent that similar factual situations have caused our Federal Courts to find that a secured transaction is voidable by a trustee notwithstanding that contemporaneous consideration passes at the time security is taken by a lender.

In the case of *Dean* v. *Davis*, 242 U.S. 438 (1917), Mr. Justice Brandeis, speaking for a unanimous court, confirmed the lower court's finding to the effect that a mortgage on real estate of the bankrupt was voidable at the insistence of the trustee. The pertinent facts which led to the finding of the court were that the bankrupt did borrow a sum of money from a lender and used such borrowed funds to pay a creditor of the debtor and soon thereafter was adjudicated bankrupt as a result of the filing of an involuntary petition. The trial court found that the lender had knowledge of the insolvent condition of the borrower at the time the loan was made and knew of the use to which the debtor would put the funds so borrowed. The court held that such transaction was a fraud on creditors notwithstanding that consideration passed from the lender to the borrower, since the financial condition of the borrower was such that an imminent bankruptcy was inevitable. The *Dean* v. *Davis* decision was considered at the time to be an extension of the law on voidability of "fraudulent" transactions. Nonetheless the decision gained support and resulted in its codification in the *Bankruptcy Act* in 1938. See Section 67d(3).

Colliers on Bankruptcy, Vol. 4, at page 548, in commenting on the landmark case of *Dean v. Davis*, said:

> ". . . The decision probably departed from the general rule that under former Sec. 67e only transfers fraudulent under the well recognized principles of the common law and the statute of Elizabeth were thereby invalidated. *But the utter lack of good faith on the part of the debtor and his transferee, and the surrounding facts of the case demanded the result reached.*" (Emphasis supplied.)

In summary, we respectfully submit that the utter lack of good faith on the part of Sapphire and Mastan and the surrounding facts of the case demand that the mortgage not be given preferred status, since to do so would promote the reckless extension of credit to the damage of the maritime industry and the American economy in general.

2. The Court of Appeals below decided to deny Todd, a ship repairer, preferred maritime lien status over the mortgage by concluding that it does not hold a tort claim as prescribed by statute since the recordation of the ship mortgage is notice to the world that the vessel is first pledged to the lien of the mortgage. As we shall hereinafter develop, the reasoning of the Court of Appeals below *begs the question* since the mortgagee was aware of the inability of the mortgagor to meet its obligation to Todd, the ship repairer.

It is not disputed that from the period May, 1966 through January, 1967 Todd, at the request of the owner, Sapphire, did furnish labor, materials and equipment and performed certain repair work on the vessel "Sandy" at its Brooklyn, New York plant. The reasonable and agreed value for such services performed on the vessel was $33,293.

The United States District Court found that on December 28, 1965 Sapphire was insolvent and that Mastan was then fully aware of the insolvent condition of the company (1 R. 35, 7a). The excerpts of the testimony set forth under Point I herein also fully supports such conclusion.

The condition of insolvency of Sapphire did not improve during the subsequent period in question, but in fact, deteriorated. The United States District Court has also found that such deterioration in the financial condition of Sapphire was known to Mastan (1 R. 35, 7a).

The United States District Court also found that on the closing of the mortgage loan, Mastan withheld the sum of $100,000.00 pending completion of certain ship repairs. However, the District Court found that on July 19th Mastan caused a letter to be signed by Sapphire requesting that $60,000. of the sum held in escrow by Mastan for ship repairs be applied by Mastan for the monthly payments becoming due on the two outstanding loans. This was done by Gold acting for Mastan as disclosed through his letters of July 21 and July 29, respectively.

In accordance with the above findings of the United States District Court, clearly supported by the testimony, it is unquestionable that at the time Sapphire requested that Todd make the repairs above noted to the vessel "Sandy" both Sapphire and Mastan knew that due to the hopelessly insolvent condition of Sapphire and the financial inability of the "Sandy" that it could not pay for the repairs performed by Todd and therefore fraudulently accepted the services rendered by Todd. Furthermore, the acceptance by the vessel "Sandy" of the said repairs for which she knew at the time of acceptance she could not pay, was fraudulent. Additionally, Mastan, knowing of the insolvent condition of Sapphire, neverthe-

less, withdrew $60,000. from an escrow account, which was created for the purpose of payment of ship repairs and applied same against its mortgage debt.

It is also clear that during the period of time in question, namely from December, 1965 to January, 1967, the "Sandy" incurred expenses for repairs, port services, stevedores, wages, salvage, fuel and supplies of such magnitude for which it had not paid, that it was inevitable and foreseeable that foreclosure actions by justifiably irate creditors would be commenced with the result that the vessel would be arrested and sold in order to satisfy these outstanding claims.

Under the circumstances, it is the contention of Todd that the solicitation and acceptance of repair services constituted a maritime tort, not merely a breach of contract so that Todd's claim is entitled to preferred maritime lien status.

Section 953 of *The Ship Mortgage Act*, 1920, part (a) and (b) identify the types of claims which will enjoy preferred maritime lien status and ultimate priority over a preferred ship mortgage.

As clearly appears from the language of *Section* 953(a), a tort claim is given the status of a preferred maritime lien and under *Section* 953(b) shall have priority over a preferred ship mortgage in the distribution of the funds from the proceeds of sale.

The case of *The Henry W. Breyer*, 17 F.2d 123 (D.C. Maryland, 1927) is substantially similar to the instant situation and it deserves close scrutiny. The *Breyer* case dealt with the proper distribution of the proceeds of sale of the steamship Henry W. Breyer and involved controversies by and between the preferred mortgagee, repairmen, suppliers to the ship, and certain shippers of merchandise.

The shipper of merchandise claimed that it was entitled to a preferred maritime lien since its claim was cognizable in tort in that the owner accepted the freight at a time when it knew, or should have known, that the vessel was unable to perform its voyage due to its financial difficulties. The court concluded that the shipper was entitled to a preferred maritime lien since as a common carrier of goods the owner breached its duty in accepting the merchandise knowing that it could not complete the voyage. Apart from the owner's breach of its duty as a common carrier the Court found that the shipper was entitled to a preferred maritime lien in that the action of the owner and of the vessel was fraudulent. The Court said, at page 131:

> "On another ground, the shippers were justified in alleging that they were damaged by acts of the vessel which amounted to torts. The complete financial inability of the owner of the vessel to comply with the obligations of a common carrier is so clearly shown by the testimony that it must have been known to the managers of the vessel when the cargo was taken aboard. The action, therefore in accepting the goods, and particularly in receiving the freight money in advance, from the intervening libelants, was in effect fraudulent. The navigation corporation was doubtless insolvent, and the situation was analagous to that which has been frequently before the courts in reclamation proceedings in bankruptcy. It is a general principle that, when a person who is insolvent purchases goods with no intention of paying for them, and conceals his insolvency and his intention not to pay, he is guilty of fraud which entitles the vendor to recover the goods. Knowledge of inability to pay when the purchase is made is equivalent to purchase with intent not to pay. Such purpose is constructively fraudulent (citations omitted). It was equally fraudulent for the ship to accept payment for services which she was clearly unable to perform."

While thus holding the shipper of merchandise entitled to a preferred maritime lien, the court in the same proceeding, for reasons unstated, refrained from elevating a stevedore's maritime lien claim to preferred status. It may be that the stevedore claimant neglected to present and develop its claim. In any event Todd's claim parallels that of the shipper of merchandise in that the actual services performed by Todd inured directly to the benefit of the vessel "Sandy" in the repair of defective parts of the vessel as opposed to a stevedore whose services are performed primarily for the benefit of the owner of the vessel and not the vessel itself. Furthermore, in the case at bar, Mastan the mortgagee, with knowledge of the insolvent condition of Sapphire, applied funds escrowed for ship repairs to its mortgage debt.

This circumstance alone, namely, Mastan's knowledge of Sapphire's insolvency, compels the conclusion that the mortgagee should in no event further profit by having its claim enjoy preferred status over that of an innocent repairman whose services were given in reasonable expectation of being paid while the vessel and owner, already insolvent, had no honest intention to pay for the repairs ordered and completed.

The most recent case on this subject, *Morrissey, et al. v. S.S. A. & J. Faith*, 252 F. Supp. 54 (D.C. Ohio, 1965) lends further support to Todd's position. In *Faith* the owner of the vessel accepted certain cargo pursuant to a contract of affreightment at a time when the S.S. Faith was already floundering on the shoals of hopeless insolvency. The court adopted the Commissioner's finding in respect to the ship's economic adventures and her owner's financial chicanery as a "shoestring" operation headed full speed for bankruptcy. In the instant case the findings of the United States District Court warrant a similar description of the ship owner's financial condition.

The court found that in *Faith*, the owner, in accepting the freight while in such a precarious financial condition, breached its duty to provide a seaworthy vessel, which breach sounded in tort and gave the shipper a preferred maritime lien ahead of the preferred mortgage *which was recorded* as provided by *Section 953 (a) and (b) of The Ship Mortgage Act, 1920*. The court found that it was unnecessary to determine if the owner's conduct amounted to tortious misconduct in light of its finding that the breach of the seaworthiness warranty was tortious in itself, and gave to the shipper a preferred maritime lien. However, it is fully justifiable to conclude that the *Faith* court would have followed *Breyer* had it not decided the issue on the seaworthiness warranty.

The district court in Maryland in the case of *Atlantic Steamer Supply Company* v. *The S.S. Tradewind*, 153 F. Supp. 354 (D.C. Maryland, 1957) appears on the surface to have reversed its position expressed in *Breyer*, *supra*, and thus set forth a total contrary finding to that expressed by the District Court of Ohio in *Morrissey*, *supra*.

In *Tradewind*, the court reviewed in depth the *Breyer* case and concluded that the fraud committed in *Breyer* was the fraud of the vessel; namely its inability to perform the voyage, while the fraud committed in *Tradewind* was the fraud of the owner, and not that of the vessel.

Tradewind and *Breyer* do not necessarily have to rest as cases incompatible with each other. In *Tradewind* the services rendered were of a kind that only indirectly benefited the vessel. The services rendered by Todd, however, provided a direct benefit to the vessel and were much more closely akin to those of a shipper of merchandise as in the *Faith* case. Furthermore, in *Tradewind*, the court did not find that there was such an abundance of unpaid suppliers, repairmen and wage claimants that arrest of the vessel by an irate creditor was almost a predictable certainty as was

the case in both *Breyer* and *Faith*. A final and most critical distinction between *Tradewind* and the instant situation is that Mastan, with knowledge of the insolvent condition of Sapphire, applied funds held in escrow for ship repairs against its mortgage debt, while in *Tradewind* there is no reference or suggestion that the mortgagee had knowledge of insolvency.

The insolvency of the vessel owner is inevitably reflected on the vessel and it is clear that in the instant situation the fraud arising from the joint knowledge of insolvency by the vessel owner and the mortgagee is a fraud of the vessel as well as that of the owner and mortgagee. The "Sandy" directly benefited by the repairs made by Todd at a time when it was obligated under a fleet mortgage in the face amount of $1,296,000 and also to other various suppliers, repairmen and sundry parties rendering services, such as wage claimants, all at a time when Sapphire was hopelessly insolvent and its financial condition was further deteriorating.

The same considerations that motivated the court to elevate maritime liens to preferred status in *Breyer* and *Faith* are present and apply with equal force in the instant situation thus causing Todd's claim for repairs to be recognized as one sounding in tort and hence a preferred maritime lien with priority over the ship mortgage. To do otherwise would seriously affect the commercial extension of credit by persons supplying seagoing vessels with repairs and supplies to the detriment of the United States maritime industry.

3. The interests of justice and fairness dictate that the doctrine of *marshalling of assets* should have been applied in this case to cause the mortgagee to seek recovery first from other sources which it has available to it prior to permitting it to exhaust the proceeds of sale of the vessel which is the only source of payment available to other maritime lien claimants such as Todd.

Courts sitting in admiralty have long applied the doctrine of marshalling of assets in the distribution of proceeds of sales of vessels. *The Edith*, 94 U.S. 518, 523.

A leading case in this area is the Supreme Court Opinion in *Meyer v. United States*, 375 U.S. 233, wherein the court, at page 236, said:

> "This court has said that the equitable doctrine of marshalling rests upon the principle that a creditor having two funds to satisfy his debt may not by his application of them to his demand, defeat another creditor, who may resort to only one of the funds (citations omitted).

The Court went on at page 237 to say:

> "In considering the relevancy of the doctrine here it is well to remember that marshalling is not bottomed on the law of contracts or liens. It is founded instead in equity, being designed to promote fair dealing and justice. Its purpose is to prevent the arbitrary action of a senior lienor from destroying the rights of a junior lienor or a creditor having less security. It deals with the rights of all who have an interest in the property involved and is applied only when it can be equitably fashioned as to all of the parties."

In *Meyer*, the Supreme Court denied the applicability of the marshalling doctrine only because the result would have caused the bank involved in said case to collect a debt from an otherwise state exempt asset. Such a factor is not relevant to the instant case.

In *United States Fidelity and Guaranty Company* v. *Long*, 214 F. Supp. 307 (Dist. Ct. Oregon, 1963), the court at page 319 said:

> "Generally where two creditors seek satisfaction out of the assets of a debtor and one of them can resort to two funds and the other is limited to one, the former may be required to seek satisfaction out of the fund which the latter creditor cannot touch, so that the latter may have his claim satisfied out of the fund which is subject to the claims of both" (citations omitted).

In *U. S. Fidelity*, the court applied the doctrine of marshalling of assets and required the United States to proceed against the contractual bond and not a statutory bond for the reasons cited above.

In the instant case we have the facts sufficient to justify the application of the doctrine of marshalling of assets. Mastan has at least two funds to proceed against in order to collect the debt and possibly more than two such funds. All of the funds which Mastan has available to it are funds of the debtor. On the other hand, the maritime lienors, such as Todd, and others similarly situated, can look to but one fund to satisfy their maritime liens and that is the vessel and the proceeds of sale of said vessel. To allow Mastan to collect its debt from the vessel proceeds without first proceeding against the other sources available to it for collection would unfairly defeat the rights of all maritime lienors. No clearer factual circumstances can be found for the application of the doctrine of marshalling of assets.

The other funds in question are primarily and principally the proceeds of marine insurance claims which have emanated from damage and repairs to the three vessels in question. Still other sources of funds within the reach

of Mastan but not the maritime liens are assigned charter hire and freights and accounts receivable of Sapphire, all of which were assigned to Mastan as additional security. The marine insurance funds are substantial in nature. Todd sought to offer testimony in regard to these funds but the Special Master did not permit the introduction of such testimony. The United States District Court affirmed the Special Master's ruling.

Todd is prepared to offer testimony in regard to the marine insurance claims and proceeds wherein the court could find from such testimony that Mastan assigned, transferred and delivered to the 046 Corporation, the purchaser of the "Sandy" at the U.S. Marshal's sale, marine insurance claims having at least a value of $130,000, in consideration for the nominal payment by the 046 Corporation to Mastan of the sum of $15,000. It is elementary that to the extent of the value of the insurance claims assigned there is to be a corresponding decrease in the amount of the debt. Such reduction was not ordered by the court below. In addition, Todd is prepared to demonstrate that there are various other marine insurance claims which have not been collected and which claims have been assigned to Mastan.

Todd also is prepared to offer testimony in support of a similar sale of marine insurance claims by Mastan to the 046 Corporation which also purchased the Sapphire Gladys, at a sale in Rotterdam, Holland. The sale of these marine insurance claims again was made for a nominal consideration, or for possibly no consideration at all. It is believed the insurance claims have a value of at least $105,500. Additionally, Todd intended to offer testimony establishing that marine insurance claims having substantial value also exist on the Gladys and on the Etta.

The Court of Appeals below concluded that the doctrine of marshalling of assets was not applicable since the assets sought to be marshalled were non-maritime property be-

yond the jurisdiction of the admiralty court. This position is in conflict with the holding in *The Buffalo*, 4 Fed. Cas. 2, 111 (D.C.E.D. Mich.; 1877) and the admiralty ruling therein of the highly regarded District Judge Brown. Commenting on the ruling in this case it is stated in 38 C.J., Sec. 9 at page 1371:

> "The operation of the principle of marshalling is not affected by the nature of the property which constitutes the double fund, but applies whenever a paramount creditor holds collateral security or can resort collaterally to other real or personal estate for the satisfaction of the debt." (Citing The Buffalo, supra).

It is worthy to note that Mastan admitted at the hearings before the Special Master that it has the legal right to seek collection of the maritime insurance funds, the accounts receivable, and the charter hire and freights, in that it is the named loss payee on the insurance policies and it holds a security interest in the other accounts. These facts provided full justification for the application of the doctrine of marshalling of assets since it establishes that Mastan can proceed against the other fund or funds, if it chooses or is directed to do so, but that Todd and other maritime lien creditors similarly situated have no standing to move against the marine insurance proceeds or other assets.

If, against this background, the preferred status of the mortgage should be upheld and the doctrine of marshalling of assets rejected, the result would truly be unconscionable in that Mastan would be placed in a position not only to collect the proceeds of sale of the "Sandy", "Etta" and "Gladys" but also to then look to the other funds to make itself whole while the claims of the maritime lienors would be completely frustrated—claims that would never have come into existence but for the loan made by Mastan to Sapphire.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted and the decision of the court below reversed, or alternatively the proceedings should be remanded to the District Court for the introduction of testimony relevant to the subject of marshalling of assets.

Respectfully submitted,

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APPENDIX A-1

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 17879

THE MASTAN CO., INC.

v.

WILLIAM STEINBERG, ET AL.

v.

STEAMSHIP SAPPHIRE SANDY,
HER ENGINES, TACKLE, ETC.,

Defendant,

TODD SHIPYARDS CORP.,

Appellant.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW JERSEY

Argued October 6, 1969

Before McLAUGHLIN, FORMAN and ALDISERT, *Circuit Judges.*

Opinion of the Court

(Filed November 18, 1969)

ALDISERT, *Circuit Judge.*

At stake in this admiralty action is the distribution of $55,085.37, deposited in the Registry of the court below following the foreclosure and sale of the ship *SS Sapphire Sandy* by the United States Marshal. A Special Master

determined that the Mastan Company was entitled to the entire proceeds of the sale as holder of a valid first preferred mortgage on the vessel. Todd Shipyards Corporation, a creditor of the ship, has appealed the district court's confirmation of the master's report.

In December, 1965, the Sapphire Steamship Lines borrowed $1,296,000 from the Mastan Company. The sole purpose of the loan was to enable Sapphire to purchase three ships, one of which was the *Sandy*.[1] To secure the loan Sapphire executed a First Preferred Ship Mortgage to Mastan on the purchased vessels. The mortgage and accompanying documents were drafted and recorded in conformity with the Ship Mortgage Act of 1920, 46 U.S.C.A. § 911 et seq.

Thereafter, in May and June, 1966, Todd performed certain repair work on the *Sandy* for which an unpaid balance of $35,000 existed when Sapphire filed a Chapter XI petition in the Southern District of New York. Sapphire's action prompted Mastan to foreclose its delinquent mortgage of the *Sandy* then docked in a New Jersey harbor.

In its assault upon the priority afforded Mastan's mortgage in the court below, Todd places primary emphasis on the interpretation of Section 922 of the Ship Mortgage Act. That section provides that a mortgage shall be afforded preferred status under certain conditions, one of which is that:

---

[1] The original agreement was executed on December 28, 1965, and provided for the loan of $1,296,000. The first part of the transaction was accomplished on December 29 when the sum of $864,000 was advanced to Sapphire for the purchase of two ships. Included in this amount was a check for $100,000 made payable to Sapphire and endorsed to Mastan to be held pending completion of repairs on the purchased vessels. The second part of the agreement was completed on January 21, 1966, when the additional sum of $432,000 was advanced to Sapphire to buy a third vessel. In August, 1966, the parties entered into an agreement extending the loan for a period of twenty-seven months, thereby reducing the monthly payments.

"(3) An affidavit is filed with the record of such mortgage to the effect that the mortgage is made in good faith and without any design to hinder, delay, or defraud any existing or future creditor of the mortgagor or any lienor of the mortgaged vessel."

Although such an affidavit was filed with the Sapphire-Mastan mortgage, Todd asserts that it was a sham which in no wise reflected the parties' actual intent which was to defraud future creditors by encumbering the vessels with massive liens so that no assets of the debtor remained available for the benefit of creditors.

Accepting the postulate that the mere filing of an affidavit of good faith will not legitimize a mortgage conceived in fraud, the Special Master concluded after receiving extensive evidence that there was "no intention or intent to deceive any creditor nor was there any design to hinder, delay or defraud any existing creditor or future creditor." On the contrary, the master found that the Sapphire-Mastan arrangements were "all for the betterment of the operation of the business," and that there were "affirmative acts and deeds of 'good faith.'"[2] At this juncture, it will be observed that even Todd's expert witness was unwilling to employ the term "fraud" in response to a specific inquiry by the master but chose instead to employ the term "imprudent" to the Mastan-Sapphire transactions.

Our own examination of the record leads us to conclude that there was abundant evidence of good faith on the part of the parties to the mortgage. To be sure, we are not left with any impression that the lower court's determination

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[2] As further evidence of the good faith of the parties, the Special Master noted that Sapphire's corporate officers made personal contributions of approximately $450,000 to enable Sapphire to purchase the three vessels.

of good faith was "clearly erroneous." In the absence of such clear error, the conclusions reached below must stand. McAllister v. United States, 348 U.S. 19, 20 (1954).

In an attempt to overcome this determination, Todd suggests that the subjective good faith of the parties does not control where the mortgagor is hopelessly insolvent at the time of the execution of the mortgage. Conceding that the Ship Mortgage Act contains no such definition of fraud, Todd urges the application of the New York Debtor and Creditor Law, Sections 272 and 274, which provide essentially that fraud is presumed as a matter of law where a person making a transfer is, or will be rendered insolvent, and the transfer is made without fair consideration. It is Todd's position that because the Mastin-Sapphire mortgage was executed in New York, that state's interpretation of "good faith" in debtor-creditor transactions should be used in gauging the standards employed in the federal statute.

Assuming that state standards have any application to the Ship Mortgage Act, the Appellant's argument must fail against the specific finding by the Special Master that the mortgage was "partially supported by full and fair consideration." This finding in itself, which we do not view as clearly erroneous, would remove the transaction from the purview of the New York statute.

Moreover, we cannot accept the contention that state standards are controlling. Admiralty is by constitutional directive within the orbit of federal concern. Panama R.R. Co. v. Johnson, 264 U.S. 375 (1924). And where, as here, Congress has legislated standards for the enforcement of suits in admiralty, federal standards are controlling. Pope v. Talbot, Inc. v. Hawn, 346 U.S. 406 (1953). While the facts of the present case do not necessitate any extensive examination of the elements of "good faith" as employed in the Act, it seems clear that to engraft the various nuances of state law onto federal legislation would introduce

an undesirable lack of uniformity in the interpretation of congressional enactments. In the present case, it would condition the validity of ships mortgages on the idiosyncracies of local law rather than their conformity to national interests.

The clear congressional intent in enacting the Ship Mortgage Act was to encourage and promote the continued development of the American merchant marine. Even the most casual familiarity with this industry will reveal the recent difficulties it has experienced in competing in the international market. Its efforts to extricate itself from its diminishing financial dominance in the world market are matters of vital national concern. The further imposition of state standards on this industry would be an unwarranted intrusion into an area which bespeaks its national implications. We conclude that the court below acted correctly in holding that the New York statute was not controlling on the issue of good faith. *See U.S. v. Oil Screw Ken Jr.*, 275 F. Supp. 792 (E.D. La. 1967); *U.S. v. American Gas Screw Franz Joseph*, 210 F. Supp. 581 (D. Alaska 1962).

Our conclusion that the Mastain mortgage was valid does not end the inquiry. Todd further contends that it was entitled to share in the proceeds of sale under the equitable doctrine of marshalling assets. The Special Master concluded that marshalling was inappropriate be-

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Todd also claims priority as a tort claimant under 46 U.S.C.A. § 953. It does so on the basis of the assertion that it was defrauded into making repairs. It seems clear, however, that such a claim of fraud, by the mutuality of the ship to respond to the payment for repairs, is not a tort claim within the meaning of § 953, since recordation of the ship mortgage is notice to those who subsequently contract with the vessel that it is first pledged to the lien of the mortgage. *See Diane v. the SS Seathunder*, 191 F. Supp. 807 (D. Md. 1961); *Atlantic Steamer Supply Co. v. the SS Tradewind*, 153 F. Supp. 351 (D. Md. 1957).

cause the assets were non-maritime property beyond the jurisdiction of the admiralty court.[1] We agree. Moreover, there is serious doubt whether marshalling is ever proper where its effect would relegate the preferred mortgage to a status inconsistent with the express priority given it by statutory direction.

The judgment of the district court will be affirmed.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

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[1] The assets involved were maritime insurance proceeds in the hands of British underwriters. There were also certain accounts receivable which the master determined to be either nonexistent or having no worth.

APPENDIX A-2

Opinion

UNITED STATES DISTRICT COURT

DISTRICT OF NEW JERSEY:

Civil Action No. 284—67

On Motion To Confirm Master's Report

OPINION

THE MASTAN COMPANY, INCORPORATED,

Plaintiff,

and

ALLIED VAN LINES, INC., *et al.*,

Intervenors,

vs.

S. S. SAPPHIRE SANDY, her engines, tackle, etc.,

Defendant.

APPEARANCES:

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GROSS & NOVAK, ESQS.

By EDWARD GROSS, ESQ.
Attorneys for Todd Shipyards Corporation

Appendix A-2—Opinion

WORTENDYKE, District Judge:

The Mastan Company, Incorporated (Mastan) filed its complaint on March 15, 1967 against the S. S. Sapphire Sandy (Sandy), her engines, boilers, tackle, apparel, furniture, etc. to foreclose the first preferred fleet ship mortgage, dated December 29, 1965, and thereafter amended and supplemented, given by Sapphire Steamship Lines, Inc. (Sapphire), the owner of the vessel, to secure indebtedness of Sapphire to Mastan.

The Sandy, being within the jurisdiction of this Court, was sold by the United States Marshal for the District of New Jersey on May 22, 1967 for the sum of $160,000 and said sale was confirmed by this Court's Order of May 24, 1967. The proceeds of the sale of said vessel (the fund) were deposited in the Registry of this Court pursuant to the Order confirming the sale.

By its Order of June 30, 1967 this Court appointed Louis N. Freeman, Esq., as Special Master pursuant to F.R.C.P. 53, to hold hearings and determine the amount and priority of all claims filed against the Sandy and to report his findings to this Court.

On August 19, 1968 the Special Master filed his report with the Clerk of this Court in which after reviewing the evidence presented before him he found and reported as follows:

> "Accordingly, there is absence of any fraud, delay or hindrance, or any design to the detriment of all creditors and, * * * [there were] affirmative acts and deeds of 'good faith' as set forth and recorded in the preferred fleet ship mortgage of December 29th, 1965, and its supplemental agreements and mortgages.
>
> Accordingly, Todd has no fixed rights to participate and receive any money from the fund in the Registry of the Clerk of the Court. Todd did

not offer any *pro forma* proof establishing its right to assert a maritime lien."

The valid amount of Mastan's claim entitled it to receive the balance of the fund in the Registry of the Clerk of the Court, less taxed costs and disbursements to be assessed and ordered to be paid by the Court.

It is recommended that all interest, penalties for late payments and other finance charges as of February 28th, 1967 be denied; and that Mastan accordingly be allowed immediately to withdraw from the Registry of the Court the remainder of the balance of the sum of $61,183.67, after current taxed costs are paid.

The final order in the cause should award the entire proceeds in the registry, after payment of taxed costs, to Mastan."

To the report of the Special Master objections were filed respectively by Mastan and Todd Shipyards Corporation (Todd), which were argued before the Court on October 14, 1968. At the conclusion of the oral arguments on that date the Court reserved decision and now embodies its decision in this Opinion.

Mastan urges five objections to the Master's Report, viz:

1. The finding that the preferred mortgage debt owed to Mastan is limited to $866,580.43;

2. The finding that all interest, penalties for late payments, and finance charges as of February 28, 1967 should be denied;

3. The finding that all interest, penalties for late payments and finance charges should be cut off as

of March 13, 1967, the date upon which Sapphire filed its petition under Chapter XI of the Bankruptcy Act;

4. The finding that the interest rate, penalties for late payments and finance charges which Mastan agreed to pay to Sapphire were excessive;

5. The findings referred to in objections 1 through 4 supra were unnecessary to the Special Master's decision because moot, for the reason that the amount in the Registry of the Court is far below the amount of the preferred mortgage debt.

Mastan therefore asks the Court to confirm the Master's Report in all respects excepting those features to which Mastan objects, and to assess against Todd, in favor of Mastan, costs and expenses attributable to the presentation of evidence relevant to the marshalling of assets and the alleged fraudulent character of Mastan's ship mortgage.

In support of its contention that the Master's report should not be confirmed Todd contends:

1. The mortgage of Mastan is not entitled to preferred status under the Ship Mortgage Act of 1920;

2. The equitable concept of marshalling of assets is applicable in the instant proceedings;

3. The interest and finance fees should reduce the debt owing to Mastan to $805,243.85.

In support of its contention that Mastan's mortgage is not entitled to a preferred status Todd summarizes the evidence before the Master as follows:

Appendix A-2—Opinion

Mastan loaned Sapphire $1,296,000 with knowledge that the borrower was insolvent in December of 1965. The money so loaned was used by Sapphire for the acquisition of vessels, which were simultaneously encumbered by the mortgage to Mastan. Moreover Mastan obtained liens on all other available assets of Sapphire which otherwise could have been available to existing creditors of Sapphire. The shipowner's ultimate default in its monthly mortgage payments caused substantial losses to its existing creditors in December 1965 and to its future creditors as well. Nevertheless, in August of 1966 Mastan increased its mortgage lien by $53,000 under an agreement which provided a 2% penalty charge against the shipowner on any payment default. Accordingly, Todd argues that the conduct of Sapphire and Mastan from early December 1965 through August 1966 did not disclose actions in good faith but constituted fraud which hindered, delayed and obstructed existing and future creditors of Sapphire. The testimony of the witness Pogash is referred to as supporting the alleged harm to existing creditors because moneys used to meet the monthly mortgage payments to Mastan were thereby diverted from the payment of existing indebtedness, and future creditors were injured by relying upon the security of a maritime lien which would be valueless if the mortgage were deemed preferred. It is Todd's contention in this respect that future creditors of Sapphire would be justified in assuming that there was some equity in the vessel over and above the mortgage, and that they would not have rendered services or supplied materials to the vessel "if Mastan did not grant this fraudulent mortgage to Steamship." The evidence is uncontradicted that both the mortgagor and mortgagee were fully aware when the mortgage loans were made that the mortgagor was insolvent. Todd argues therefore that Mastan knew of Sapphire's insolvency when making the loans. All of the loan proceeds went to

parties other than Sapphire, and Mastan obtained liens on all of Sapphire's assets. Todd contends that the result of the transaction was the completion of Sapphire's financial ruin to the detriment and harm of its existing and future creditors. Therefore Todd contends that the mortgage transactions were fraudulent, and that the mortgages should be held null and void and disentitled to priority under Section 922(a)(III) of the Ship Mortgage Act.

It is obvious that, if the mortgages were valid and entitled to priority under the statute, Todd's other objections to the Master's Report become moot because the balance of the proceeds of the sale of the Sandy is insufficient in amount to satisfy the principal sum of any of the promissory notes secured by the mortgage.

In support of Todd's contention that there was an absence of good faith in the ship mortgage transaction it refers to the following aspects of the evidence before the Special Master:

> "1. The Sapphire was hopelessly insolvent;
>
> 2. Its insolvency was known to Mastan and confirmed by the expert testimony of Pogash;
>
> 3. The degree of Sapphire's insolvency rendered its abiiity to service its mortgage obligation inconceivable."

With respect to the possible mootness of Todd's claim, it was disclosed on oral argument that the amount of that claim was approximately $35,000. The fleet mortgage of Mastan covered 3 vessels; 2 of them were sold in the Netherlands for a gross price of $733,000. Todd contends that that amount plus the amount in the Registry of this Court, together with other assets of Sapphire consisting primarily of insurance proceeds "may be more than sufficient to satisfy a valid mortgage if the court finds it to be

such under the Ship Mortgage Act and still permit at least a partial dividend to maritime lien creditors."

Todd also contends that the Special Master committed error in excluding evidence offered in support of Todd's contention that there should be a marshalling of Sapphire's assets between Mastan and Todd. It was reported that in certain insurance policies covering the vessel Sapphire was named as insured and Mastan as loss payee and that only Mastan could claim the proceeds of the policy. These proceeds approximated $135,000, but were sold by Mastan for $15,000. Todd claims to have evidence of other insurance claims on the three vessels which were then in process of collection, but complains that the Special Master limited proffered testimony by the collector who expressed willingness to deposit the funds collected in the Registry of this Court.

Todd points out that at the hearings before the Special Master all parties present stipulated that evidence should first be presented by Mastan on its preferred ship mortgage claim and that the Special Master should then report upon the validity and extent of that claim before receiving evidence in behalf of the Maritime Lien claimants. This stipulation was entered into to conserve time and because of the recognition that if the ship mortgage were found valid in an amount in excess of the fund in the Registry of Court, the other maritime lien claims would be rendered moot. Todd however contends that the finding of the Special Master that Todd and other maritime lien claimants waived their claims by failing to offer testimony in support thereof is unwarranted. With this contention the Court concurs.

The evidence disclosed that Sapphire's initial loan agreement with Mastan was made on December 28, 1965, and contemplated an amount of $1,296,000. Although $864,000 of the foregoing amount purported to be loaned to Sapphire no part of that amount was actually paid over to Sapphire;

but pursuant to a letter of instructions, dated December 29, 1965, prepared by Mastan, Sapphire directed Mastan to disburse the loan as follows:

(a) $205,000 on account of the purchase of Sandy from Overseas Carriers Corporation;

(b) $495,000 on account of the purchase of the Natalie (Now Sapphire Gladys) from International Carriers;

(c) $100,000 to be withheld by Mastan pending completion of certain ship repairs by check payable to Sapphire and endorsed by it to Mastan;

(d) $64,000 representing a finance fee, by check of Mastan to Sapphire and by Sapphire endorsed back to Mastan.

Simultaneously with the execution of the letter of instructions Sapphire executed a promissory note for $864,000 to Mastan payable in monthly installments of $39,840 over a term of two years with a collateral note guaranteed by Sapphire and its corporate affiliates. The mortgage note secured by the Preferred First Fleet Mortgage represented a loan of $800,000 for a term of two years plus a finance fee of $64,000 representing interest at the rate of 8% on the principal of the note. The check for $64,000, although payable to Sapphire, was immediately endorsed back to Mastan. Although Sapphire had no use of the amount of finance charge, it was required to pay interest at the rate of 6% thereon as well as upon the sum of $100,000 while held in escrow pending completion of the ship repairs. Out of this escrow deposit $60,000 was applied by Mastan against monthly payments due under the terms of the loan.

On January 21, 1966 Sapphire gave its promissory note to Mastan for $132,000, with another letter of instructions prepared by Mastan authorizing the disbursement of that

amount by two checks. One for $400,000 payable to Oceana Clippers Inc., for the purchase of the M/S. *Sapphire Etta*, and the other in the amount of $32,000 payable to Sapphire and immediately reendorsed by it to Mastan which represented a finance fee computed at the rate of 8% for a two year period on the loan of $400,000. Upon this finance fee as well as upon the principal of the $400,000 loan Mastan charged interest at the rate of 6% per annum.

On July 19, 1966 Mastan caused a letter to be signed by Sapphire requesting that $60,000 of the sum held in escrow by Mastan, for ship repairs, pursuant to the letter of December 29, 1965, be applied by Mastan to the monthly payments becoming due on the two outstanding loans. This was done by Martin Gold, acting for Mastan, as disclosed by his letters of July 21 and 29 respectively. By agreement between Mastan and Sapphire the mortgage loans were extended and the amount of the monthly payments called for by the terms thereof was reduced from $58,000 to $33,000. The testimony of Mastan's Vice President, McGreevey, disclosed that he received on or about August 10, 1966, a certified financial statement, dated July 29, 1966, from which it appears that Sapphire's financial condition deteriorated during the period commencing with the date of the making of the initial loan, and that Sapphire was hopelessly insolvent. Nevertheless on August 29, 1966, Mastan and Sapphire entered into a supplementary agreement extending the mortgage loan for 27 months from August 29, 1966 and reducing the required monthly payments under the mortgage to $33,386.26. At the same time Mastan loaned Sapphire an additional sum of $52,817.73 which was not disbursed to Sapphire but charged as an additional finance fee and added to the unpaid balance of $96,000 as of August 29, 1966. This latest finance fee of $55,817.73 was never disbursed to Sapphire but merely treated as a loan under the agreement between the parties.

Appendix A-2—Opinion

The Special Master found, and this Court agrees, that the finance fee of $64,000 on the loan of $800,000, and the finance fee of $32,000 on the loan of $400,000, were excessive. Todd concedes that a finance fee of $38,490 (4% of $800,000) and a finance fee of $18,222 (4% of $400,000) would be appropriately allowable but that a finance fee of $52,817.73 representing interest on a principal amount never advanced to Sapphire was entirely disallowable. Therefore Todd contends that the debt owing by Sapphire to Mastan should be fixed at $805,243.85 and not $866,580.43 as fixed by the Special Master.

Although the record of the mortgage as filed under the Act includes an affidavit by the mortgagor "to the effect that the mortgage is made in good faith, and without any design to hinder, delay or defraud any existing or future creditors of the mortgagor, or any lienor of the mortgaged vessel," Mastan contends that the evidence before the Master fails to support the averment of the affidavit.

In *Pascagoula Dock Stafiton* v. *Merchants & Marine Bank*, 271 F.2d 53 (5 Cir. 1959), relied upon by Todd, a preferred ship mortgage was held valid and the lien thereof preferred and paramount to maritime liens accruing subsequent to its effective date in the absence of its use in fraud of creditors. At page 54 of the Opinion it is stated that:

> "* * * except for such circumstances [proof and finding that mortgagor and mortgagee undertook to use the device of a preferred ship mortgage in fraud of creditors] there is no statutory obligation on the part of the mortgagee to make any inquiry. It might, of course, affect the status of the mortgage as to prior liens—* * * but an absence of inquiry does not vitiate the mortgage as such. The mort-

> gagee may, and perhaps ought for his own protection, require the mortgagor to disclose in writing prior to the execution of the mortgage the existence of any maritime liens, prior mortgages or other obligations. * * *
>
> * * * * *
>
> * * * But the statute does not impliedly forbid separate and distinct preferred ship mortgages on several vessels as security for a single debt. The purpose behind Section 922(e) and (f) is to make certain that where several properties are covered in a *single* mortgage that the special statutory mortgage lien shall or may be released as to any one property on the payment of a specified or ascertainable sum. * * * Where the mortgage covers but a single vessel, there is no need to apportion as between it and nonmaritime property or other vessels. In such case the documents of the particular vessel concerned will reflect that she is subject to a full preferred ship mortgage lien to the extent of the debt, whatever it might be."

There was no evidence before the Master in this case of the existence of any maritime or other lien upon any of the vessels covered by the mortgage at the time the loan agreements were entered into between the parties. There was no refutation of the allegations that the mortgage and its supplemental agreements were timely filed and recorded in strict compliance with the statute. The mortgagor was a corporation and may not plead usury. However exorbitant the finance charges and interest rates imposed by the lender may appear, they were agreed to by the borrower and its incurrence of the consequent obligations was not in fraud of any then existing creditor or maritime lienor. The Master's finding that the mortgage and its supplemental agreements constituted a preferred lien upon the

vessels covered thereby was amply supported by the evidence before him and he therefore properly excluded testimony proferred to impugn the loan transactions for which the mortgage and related documents were given as security.

There remains the contention that the Master in the exercise of the inherent equitable jurisdiction of this Court should have applied the doctrine of "marshalling". Todd asserts that if such doctrine had been applied by the Master Todd's claim would have found support to a degree against the fund in the Registry of this Court. The Master refused to apply such a doctrine and this Court affirms him in having done so.

In *National Shawmut Bank* v. *The Winthrop, The Dorchester, The Quincy*, 134 F. Supp. 370 (D.C. Mass. 1955), the Court held that a ship mortgage prior to the enactment of the Act was not a lien with which suppliers to the vessel need reckon even after the enactment "ante-mortgage suppliers had to take their chances of the value of their liens being reduced by subsequent suppliers, but did not have to concern themselves about subsequent mortgages * * * ." Post-mortgage suppliers "are subject to any prior mortgage, even if they did not know of it, * * * ." The Court in *Shawmut* ruled that the order of payment of the proceeds of each vessel covered by the mortgage should be as follows:

"(1) the ante-mortgage liens, except any barred by laches at the date of the mortgage;

(2) the mortgage;

(3) the post-mortgage liens, * * * ;

(4) * * * liens guilty of laches at the date of the mortgage."

In the present case we are not concerned with any ante-mortgage liens and therefore out of the proceeds of sale of the Sandy the mortgagee is entitled to be paid.

Appendix A-2—Opinion

With respect to the contention of Todd that the equitable doctrine of marshalling should have been applied by the Master, it is clearly inapplicable here because the creditor (mortgagee) had only the single fund represented by the balance of the proceeds of the sale deposited in the Registry of the Court out of which to satisfy its debt. *Sowell* v. *Federal Reserve Bank*, 265 U.S. 449 (1925). And compare *Meyer* v. *United States*, 375 U.S. 233 (1963).

For the reasons hereinabove set forth the Report of Louis N. Freeman, Esq., as Special Master, filed with the Clerk of this Court on August 19, 1968, will be in all respects confirmed and an Order may be presented so providing.

REYNIER J. WORTENDYKE, JR.
United States District Judge

APPENDIX "B"

THE SHIP MORTGAGE ACT OF 1920

(46 U.S.C.A. 922(a)(3), 953(a)(b))

§ 922. Preferred mortgages

(a) A valid mortgage which at the time it is made, includes the whole of any vessel of the United States (other than a towboat, barge, scow, lighter, car float, canal boat, or tank vessel, of less than twenty-five gross tons), shall, in addition, have, in respect to such vessel and as of the date of the compliance with all the provisions of this subsection, the preferred status given by the provisions of section 953 of this title, if— As amended Sept. 26, 1961, Pub. L. 87-303, § 1(a), 75 Stat. 661.

* * * * *

(3) An affidavit is filed with the record of such mortgage to the effect that the mortgage is made in good faith and without any design to hinder, delay, or defraud any existing or future creditor of the mortgagor or any lienor of the mortgaged vessel;

* * * * *

§ 953. Preferred maritime lien; priorities; other liens

(a) When used hereinafter in this chapter, the term "preferred maritime lien" means (1) a lien arising prior in time to the recording and indorsement of a preferred mortgage in accordance with the provisions of this chapter; or (2) a lien for damages arising out of tort, for wages of a stevedore when employed directly by the owner, operator, master, ship's husband, or agent of the vessel, for wages of the crew of the vessel, for general average, and for salvage, including contract salvage.

(b) Upon the sale of any mortgaged vessel by order of a district court of the United States in any suit in rem in admiralty for the enforcement of a preferred mortgage

lien thereon, all preexisting claims in the vessel, including any possessory common-law lien of which a lienor is deprived under the provisions of section 952 of this title, shall be held terminated and shall thereafter attach, in like amount and in accordance with their respective priorities, to the proceeds of the sale; except that the preferred mortgage lien shall have priority over all claims against the vessel, except (1) preferred maritime liens, and (2) expenses and fees allowed and costs taxed, by the court. June 5, 1920, c. 250, § 30, Subsec. M, 41 Stat. 1004.

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New York Debtor and Creditor Law
(Secs. 273, 274 and 276)

§ 273. Conveyances by insolvent

Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration. Added L. 1925, c. 254, § 1, eff. April 1, 1925.

§ 274. Conveyances by persons in business

Every conveyance made without fair consideration when the person making it is engaged or is about to engage in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital, is fraudulent as to creditors and as to other persons who become creditors during the continuance of such business or transaction without regard to his actual intent. Added L. 1925, c. 254, § 1, eff. April 1, 1925.

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Appendix "B"

§ 276. Conveyance made with intent to defraud

Every conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors. Added L. 1925, c. 254, § 1, eff. April 1, 1925.

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N. J. S. A. 14:14-2

14:14-2. CONVEYANCES, ASSIGNMENTS OR TRANSFERS AFTER INSOLVENCY OR IN CONTEMPLATION OF INSOLVENCY VOID AS AGAINST CREDITORS: BONA FIDE PURCHASERS: EXCEPTIONS

When any corporation shall become insolvent or shall suspend its ordinary business for want of funds to carry on the same, neither the directors nor any officer or agent of the corporation shall sell, convey, assign or transfer any of its real or personal property, choses in action, rights or credits, nor shall they or any of them make any such sale, conveyance, assignment or transfer in contemplation of insolvency.

Any such sale, conveyance, assignment or transfer shall be null and void as against creditors, except that a bona fide purchase for a valuable consideration, before the corporation shall have actually suspended its ordinary business, by any person without notice of such insolvency or of the sale being made in contemplation of insolvency, shall not be invalidated or impeached. The provisions of section 14:14-2 shall not apply to any sale, conveyance, assignment or transfer hereafter made to The Reconstruction Finance Corporation, or to any Federal Reserve bank, or to any bank being a member of the Federal Reserve system, or to any other corporation under State or Federal supervision, as security for the repayment with interest of any sum or

sums of money to be loaned or advanced to such corporation at or subsequently to the time of the making of such sale, conveyance, assignment or transfer.

The provisions of section 14:14-2 shall not affect or impair the validity or enforceability of any security interest duly perfected in accordance with the Uniform Commercial Code or of any mortgage on real property given for valuable consideration. As amended L. 1964, c. 146, § 1.

BANKRUPTCY ACT, 1938 (Sec. 67d(3))

(11 U.S.C.A. 107(d)(3))

(3) Every transfer made and every obligation incurred by a debtor who is or will thereby be rendered insolvent, within four months prior to the filing of a petition initiating a proceeding under this title by or against him is fraudulent as to then existing and future creditors: (a) if made or incurred in contemplation of the filing of a petition initiating a proceeding under this title by or against the debtor or in contemplation of liquidation of all or the greater portion of the debtor's property, with intent to use the consideration obtained for such transfer or obligation to enable any creditor of such debtor to obtain a greater percentage of his debt than some other creditor of the same class, and (b) if the transferee or obligee of such transfer or obligatiton, at the time of such transfer or obligation, knew or believed that the debtor intended to make such use of such consideration. The remedies of the trustee for the avoidance of such transfer or obligation and of any ensuing preference shall be cumulative: *Provided, however*, That the trustee shall be entitled to only one satisfaction with respect thereto.

Appendix "B"

BENEDICT ON ADMIRALTY

Sec. 78 (1967 Supplement)

"Were it to be proven that the mortgagee used the devise of the preferred ship mortgage in fraud of creditors, existing or future, the mortgage would lose its preferred status." (citing *Pascagoula*).

COLLIERS ON BANKRUPTCY

Vol. 4, p. 548

"* * * The decision probably departed from the general rule that under former Sec. 67e only transfers fraudulent under the well recognized principles of the common law and the statute of Elizabeth were thereby invalidated. *But the utter lack of good faith on the part of the debtor and his transferee, and the surrounding facts of the case demanded the result reached.*" (emphasis supplied).

CORPUS JURIS

Section 9 at page 1371

"The operation of the principle of marshalling is not affected by the nature of the property which constitutes the double fund, but applies whenever a paramount creditor holds collateral security or can resort collaterally to other real or personal estate for the satisfaction of the debt."